WSCPA Feedback on Capital Gains Tax Draft Rules (filed 3.6.2024)

April 10, 2024

We have **highlighted** the changes that the CPA profession recommends need to be made.

1. Clarify the 1256 treatment in Example 5.

    a. With the added language in the rule around the sale or exchange we interpret that the taxable amount in Washington would be the 60% federal treated long-term capital gains (LTCG) with removals for anything not held for more than a year and sold. **Example or rule should specify the correct treatment.**

    b. For the 18-month contract, in the example in federal law it would have an adjusted basis. Since the Washington State Capital Gains Excise Tax (WSCGET) starts based on the federal treatment we assume that would be the case in this example as well, but extra clarity would be helpful. **Clarify how any basis adjustments should be calculated.**

2. Clarify 1400Z scenarios in Examples 6, 7, and provide a new example.

    a. Examples 6 and 7 about 1400Z-1 and 1400Z-2 cover only the initial gain deferral (Example 6) and taxation if the qualified fund investment is sold prior to 12/31/2026 (Example 7).

        i. In Example 6, it says that Joseph must include the $1.3M long-term capital gain from sale of stock for Washington purposes. In this fact pattern, that is likely true because the transaction is sale of stock, not real estate. However, if that sale of stock was that of a qualified family-owned small business, then the $1.3M is not necessarily taxable. **Please clarify Example 6 to note that the $1.3M long-term capital gain is includable unless it qualifies under another Washington statutory exemption or deduction.**

        ii. In Example 7, because the qualified fund might be real estate or some other vehicle that has Washington nuances, we appreciate that you did not include a specific amount as being taxable because there are facts and circumstances. **We suggest that in addition to the reference to IRC 1001, 1011 and 1012, to also include a phrase such as "and RCW 82.87 as to taxability, exemptions or deductions as may be applicable for the fund investment which was sold."**

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b. There is also a third possible scenario for 1400Z which should also be included as an example. The example should address if the investment is still owned on 12/31/2026.

   i. Under the IRC, if an investment is made in a qualified fund, the federal gain is not necessarily forgiven, instead it is deferred and a portion of the deferred gain could be taxable for federal purposes in the 2026 year if the fund is still owned by the taxpayer on 12/31/2026. **Please add an example for this fact pattern.** We believe that in general, the gain recognized for federal purposes in 2026 under these circumstances will be entirely exempt for Washington purposes, because the only reason the gain will be includible in the federal return is solely due to the provisions of 1400Z-2 and not from a sale or exchange occurring in 2026. Moreover, the federally-taxable amount in 2026 is from a sale or exchange which either pre-dates the Washington tax statute, or was otherwise recognizable for Washington in the year of the actual sale, or qualified for a Washington exemption or deduction.

3. General language change from "properly reported federal net LTCG" to "had federal net LTCG".

   a. Was there a specific reason this language was changed? Does this mean that DOR will be auditing returns for federal tax purposes as well?

4. Depreciable property references to IRC 167 and IRC 197 contradict each other.

The rule stating that "Intangibles amortizable under IRC 197 do not qualify for [the depreciable property exemption]" misses that IRC 197(f) (7) states intangibles of the section are treated as depreciable property as defined in IRC 167. So, an intangible under IRC 197 is treated as depreciable property under IRC 167. **The distinction that is being created in the rule is incompatible with the IRC and the language should be adjusted to clarify the proper treatment.**

5. **Clarify documentation requirements for LTCG from passthrough entities which are not taxable for the WSCGET.**

There are likely significant long-term capital gain transactions that appear on Schedule K-1 that are included in federal LTCG on Schedule D, but which are excluded from the Washington tax for various valid reasons (real estate, depreciable property, etc.). Many individuals with these transactions will not be required to file a Washington return, since the exclusions will put them under the threshold for tax owed. When IRS information is shared, the information on the taxpayer's Form 1040 will only reflect that there was a gain that flowed through from a passthrough entity; there will not be information

to provide certainty that the non-subject income was or was not a valid exclusion. Additionally, the K-1 itself does not include this information. If the taxpayer were to inquire about the detail of the K-1 income items, they would likely get a very simple answer from the entity such as "it was real estate."

With the above in mind, **the rules need to specify what documentation a taxpayer should obtain and retain from the entity issuing the K-1.** Documentation requirements should be defined for situations when a tax is owed and exclusions applied, or by contrast, when no tax is owed and no return is filed.

6. There is some clarity granted to the treatment of non-grantor trusts as not pass-through entities. However, **three problems still remain that need guidance.**

   a. The legal questions others have raised with the taxability of non-grantor trusts and their beneficiaries in light of the United States Supreme Court case *North Carolina v. Kaester* and Washington Supreme Court case *Covell v. City of Seattle* remain concerning due to the uncertainty they present for the legality during estate planning.

   b. Guidance is still needed on the definition of "residence" for these entities. If residence is defined as the residence of the beneficiary, when is the residence determined, at the time of the gain or the time of the distribution?

   c. Guidance is also needed on how distributions that span multiple tax years will be treated, i.e., if the sale happens in one year but the distribution is over several years, when is the income to be reported?

7. It will be prudent to clarify rules for situations when returns are not filed.

   a. Clarify how audits will work when federal net LTCG are above $250,000 but no Washington tax was paid. Will the DOR audit those instances automatically or after looking at other documentation?

      i. **What types of documentation should a taxpayer collect and retain if no tax was paid?**

   b. **Establish by rule whether the statute of limitations period for filed returns and non-filed returns are the same.**